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ABSTRACT

This report responds to the 1992 Virginia General Assembly's request of the State Council of Higher Education to "study the efficacy and appropriateness of establishing a prepaid tuition trust program within the Commonwealth's system of higher education." They asked that the study include, at least, an examination of programs in other states; the potential social, financial, and educational implications of such a program; and the recommended procedures and policies for the implementation of prepayment programs. The report addresses issues to be considered in advance of taking any final action. It examines the existing pre-paid tuition programs and the options available to Virginia; it also considers such questions as who bears the risk, the tax implications, the implications for financial aid, and what the educational advantages are of having a pre-paid tuition program. The bulk of the report focuses on the "Pay in Advance" options that are available to parents and the specific issues related to pre-paid tuition programs. The role and future of the existing college savers program and the proposed pre-paid tuition program are discussed within sections that (1) summarize the programs offered by the federal government and by other states and examine the major issues related to such programs, (2) provide a status report on current financial aid programs available to Virginia's students, (3) describe the loan programs offered in Virginia, (4) estimate the potential demand for a prepaid tuition program in Virginia, (5) examine the assumptions about investment yields needed to support such a program, and (6) present recommendations for considerations by Virginia's Governor and General Assembly. (GLR)

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ED 363 212

REPORT ON PREPAID TUITION PROGRAM

There was considerable discussion about the cost of higher education during the 1992 session of the General Assembly. A portion of the discussion focused on ways the Commonwealth could assist students and parents pay for college through increased savings or other prepayment programs. This has become a serious concern for parents as tuition rates have grown at double-digit rates in the last three years and averaged more than nine percent increases over the last 12 years. Parents and students are fearful of their ability to pay for college. This is a timely topic and an appropriate state policy question.

Several bills were introduced, but not approved, in the 1992 session of the General Assembly to establish a Virginia Prepaid Tuition Fund and implement a pre-paid tuition program. In addition to bills to create such a program, Delegates Cantor and Mims sponsored House Joint Resolution Number 200 and Senator Stosch sponsored Senate Joint Resolution Number 48. The two study resolutions were combined in the final actions approving House Joint Resolution Number 200.

The study resolution requests the State Council of Higher Education, in cooperation with the Department of the Treasury, to "study the efficacy and appropriateness of establishing a prepaid tuition trust program within the Commonwealth's system of higher education." The Council is asked to submit its findings and recommendations to the Governor and the 1993 Session of the General Assembly.

The General Assembly's concerns and interests were highlighted in the language of the resolution. A complete copy of the resolution, as approved, is provided in Appendix A.

1. The pursuit of higher education may provide not only the skills and knowledge necessary to compete in an ever-changing global economy, but may also enrich the perspectives and overall quality of life of countless citizens of the Commonwealth.

2. While enrollments at Virginia's institutions of higher education are expected to increase in the future, the costs of postsecondary education are also likely to increase, potentially endangering the opportunity for many prospective students to pursue the goal of higher education.

3. Recognizing the critical value of higher education to individuals as well as the general public, a number of states have established programs to encourage citizens to pursue higher education through the advance payment of tuition at a fixed, guaranteed level.

4. These prepaid tuition programs are designed to foster timely financial planning and to broaden the accessibility of higher education.

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5. A prepaid tuition trust fund based upon the contributions of program participants might offer additional incentives to pursue higher education.

The General Assembly asked that the Council's study include, at least, an examination of prepaid tuition programs in other states; the potential social, financial, and educational implications of such a program; and the recommended procedures and policies for the implementation of prepayment programs. This draft report responds to these concerns and issues.

Many of the concerns and issues studied in this report were considered by the Council of Higher Education in its 1987 study of student financial aid. The Virginia College Savers Program was created in the 1988 session of the General Assembly. Virginia has been a leader in implementing programs to assist students and parents in coping with the costs of attending Virginia's colleges and universities. The Governor and the General Assembly have appropriated additional student aid funds to partially offset recent tuition increases.

A Pre-Paid Tuition Program appears to be a logical and desirable addition to the innovative policies and programs that make Virginia's colleges and universities among the best in the nation. While there are questions about the financial feasibility of such a program and how to avoid complications with the federal income tax code, the advantages of expanding the state's package of financial assistance programs to middle- and upper-income families are attractive and there appears to be significant interest among the citizens in such a program. These questions need to be resolved before any final action should be taken.

INTRODUCTION

The costs of higher education to students, and their parents, are rising much faster than inflation or personal income. Federal financial aid programs are not being funded to offset inflationary cost increases or growing enrollments, resulting in less aid per student. State-funded financial aid programs are being increased dramatically but not sufficiently to offset the increases in cost, enrollment growth, and the decrease in federal aid.

States have other program requirements and are seeking ways to maintain, or even reduce, the cost of maintaining their higher education systems. Federal committees are holding hearings on the costs of higher education where colleges are charged with increasing costs, decreasing quality, and being preoccupied with research agendas. The popular press and the general public have identified concern about the increasing costs and their effect on access as national issues.

The way the wide-spread concern about the cost of and access to higher education is being expressed and presented is not unlike earlier discussions associated with health care and health care costs. The similarity runs deep because both are seen as necessary services by the general public. Federal, state, and local governments see the problem as increasing costs to them; students and parents see their costs increasing and perceive that access is being constrained by institutional resources; institutions see it as a revenue problem and maybe, a public relations problem; industry sees it as an undesirable inflationary cost increase associated with recruiting

new employees and ongoing training and development programs; and society, parents, and students see both health and higher education as critical to personal, social, and economic wellbeing or mobility.

There has long been acceptance in the United States and, especially in Virginia, of the view that higher education benefits both the student and society and that the cost of education should be shared between society (federal and state government) and the individual (student and parents). Both the student and society have a basic interest in higher education. It increases both general productivity and individual earning power. Since the benefits of education are received over a long period of time after formal education ends, the cost of acquiring it should be viewed as a long-term investment. Approaches to financing higher education should include all of the normal or traditional investment strategies.[1]

The level of anxiety about higher education costs has grown in recent years because of the magnitude of the increases for both public and private colleges and universities and the continued and deepening effects of the recession and unemployment. In 1992-93, the Consumer Price Index increased 3 percent, but tuition at public four-year institutions increased by 10 percent, public two-year college tuition increased by 10 percent, and private college tuition went up by 7 percent.[2]

Sandy Baum, an economist at Skidmore College, summarized the situation and some of the issues as follows:

> Society's view of who should pay for college has been changing in recent years, though without any explicit justification for the change. Perspectives have shifted on two issues; the division of the burden among generations and the division between family and society.
>
> A generation that went to college largely at the expense of its parents and of the G.I. Bill has subsequently benefitted from the proliferation of loan programs for students. The availability of student loans has enabled today's parents to transfer much of the burden of paying for the next generation's college expenses from themselves to their children.
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> At the same time, despite the decline in real federal aid to college students in the 1980s, the last two decades have witnessed a dramatic change in general expectations about the public role in financing college. Few families now believe that they and their children should bear the whole burden of paying for higher education. Rather, they view higher education as an opportunity that should be available to all Americans; and they think that government has a major

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[1]Sandy Baum, ***"The Need for College Savings,"*** in **College Savings Plans: Public Policy Choices**, Janet S. Hansen, Ed. (New York: College Entrance Examination Board, 1990), 11-12.

[2]Jean Evangelauf, ***"Tuition at Public Colleges is Up 10% This Year, College Board Study Finds,"*** in **The Chronicle of Higher Education** (Washington, D.C.: October 21, 1992), A36.

responsibility for giving young people the opportunity to attend the college of their choice, regardless of their ability to pay. In other words, family responsibility for educating children has, to a considerable extent, given way to the idea that the government is responsible and that the children themselves should borrow to finance the remaining costs.

These phenomena involve an interesting embodiment of the prevailing philosophy of individualism. On the one hand, parents expect students to be more responsible for their own education; and taxpayers are increasingly reluctant to finance government efforts to subsidize less privileged members of society, fearing that the poor may be getting something for nothing. On the other hand, knowing that subsidies do exist, everyone wants the opportunity to partake of them. Members of the middle- and upper-middle-class expect public assistance and feel cheated if it is limited to the "truly needy."

Unless parents take more responsibility for helping their children go to college, we face a dilemma. We will either move toward greater public responsibility for educational expenses, a direction that seems contrary to the current dominant political spirit, or we will see higher education becoming accessible to a narrower and narrower segment of the population which few people would consider desirable.[3]

This anticipated, or expected, role of government is in conflict with the economic and political realities of today and the near future. Unless there is a significant change in public policy regarding higher education funding, the option of having someone else assume the financial responsibility for education will not be available to many students or parents. Even the poorest families are being asked to assume a portion of the responsibility today. That share is likely to increase.

Parents from all socioeconomic groups need to be informed of their need to anticipate having to bear a portion of the cost of education for their children. It is in the best interests of the Commonwealth to establish this expectation, communicate it widely and often, and to assist families meet this responsibility.

This study assumes that the financial aid policy recommended by the Council of Higher Education in its 1987 study on restructuring financial aid in Virginia was accepted and is being implemented. Recent actions by the Governor and General Assembly in increasing the financial aid appropriations for the 1992-94 biennium are a sign that this is the case. The Council's proposed policy helps place family and student responsibility in context with the state's responsibility as follows:

1. Responsibility to pay the cost of attending college is shared by the individual and the society to which she or he belongs. While the

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[3]Baum, 7-8.

relative share provided by the state has eroded from two-thirds to one-half, the basic principal is still endorsed by the executive and legislative bodies. Out-of-state students are expected to pay the full cost of education. In-state students are now paying one-third or more of the cost in tuition and required educational fees.

2. The assets of students and their families should be considered in determining ability to pay the price of attending college. The Council indicated that, except where students can demonstrate total financial independence, parents have a responsibility to support their children's higher education to the greatest possible extent. Students also have a responsibility to contribute earnings from their work toward paying the price of their education.

3. The primary responsibility of the state is to provide financial aid to students whose personal and family circumstances have not allowed - or do not now enable - them to accumulate assets to pay for their education. Student aid should be focused on grant and self-help assistance based upon each student's financial need. In recent years, eligibility has been extended to part-time students in several of the state programs.

4. Student loans are a secondary or supplemental form of financial aid that should be used after family contributions, earning from work, and grants are determined to be insufficient to pay the price of college. Students and parents should be encouraged to save or accumulate assets in advance of college enrollment to reduce the dependency on loans.

5. Financial aid programs should be targeted as necessary to meet the needs of different segments of the American population as they seek access to higher education and as society seeks to benefit from their participation in its civic and economic activities. In general, specific goals and objectives are more readily realized through targeted programs than through programs designed to keep costs low to all students as a form of access and participation.

Students and parents have three options for financing higher education costs that are not paid by others or waived:

1. **Pay in advance.** Parents, students, and grandparents could save sufficient funds in advance of college enrollment to fully provide for educational expenses. The savings programs available range from family savings accounts or investments, Federal Savings Bonds, state savings programs, and guaranteed tuition or prepayment programs. All have the common requirement that current assets are invested for future participation in higher

education.

2. **Pay as you go.** Students and parents pay the cost of attending out of current income. This is a common practice for many part-time students and is one of the reasons that the traditional four-year degree has become a seven or eight year accomplishment. Few families have sufficient discretionary income to utilize this approach successfully.

3. **Pay later.** Student loans, parent loans, refinanced mortgages, paying tuition on credit cards, and other forms of deferred payment have become a necessity for many families. As savings and investment yields have fallen over the last two years and changes in the treatment of interest expense in federal and state income tax calculations have been implemented, the use of debt financing as an economic hedge against inflation or investment strategy is no longer a viable option for many families. Unfortunately, because most families did not adequately prepare for today's cost of education, this is the only option open to many individuals.

MAJOR ISSUES

There are several issues that need to be considered in advance of examining the existing pre-paid tuition programs and the options available to Virginia. A brief discussion follows and further clarification is provided in each of the report sections.

WHO BEARS THE RISK? In all of the approaches to prepayment or savings programs, there are three parties: parents, institutions, and the state. If the investments or contract purchased does not yield sufficient funds to cover the cost of tuition, fees, and, in some cases, room and board, who is responsible for making up the difference? The assignment of risk influences strongly the extent that each of the parties supports the creation of such a program.

Parents might be reluctant to purchase an pre-paid tuition contract, if it does not carry a guarantee that it will be accepted as payment in full. Institutions are reluctant to participate if they 1) are forced to absorb the loss in revenues, 2) anticipate that the yield on the program will become a constraint on future increases in tuition rates, or 3) are forced to recover the lost income from other students. The state might be reluctant to initiate such a program if any shortfall in value or cash-out had to be made up from a general fund appropriation.

Any proposed program must explicitly identify the distribution of risk, and the evaluation of alternatives or programs in other states must be sensitive to the implications of various risk assignments.

WHAT ARE THE TAX IMPLICATIONS? Both savings and pre-paid tuition programs have tax implications for the parent and, maybe, the state. Sufficient programs have been established to identify concerns about tax rulings. In most situations, the IRS has held that

parents or students must declare as taxable income or long-term gains the difference between the price paid and the benefit received. Sophisticated investors will consider this in deciding how to invest their funds. Many parents will not anticipate this erosion in purchasing power of their dollars.

States must consider, in the calculation of the necessary investment yield and the pricing of pre-paid tuition contracts, what results are needed to meet, or exceed, inflationary increases in the cost of education plus the anticipated tax effects. Most states adjust for this factor by having the parent pay more at the time the contract is initiated. Ohio appears to have a successful formula for this calculation.

The tax implications for the state, foundation, or authority created to operate the pre-paid tuition program are more vexing and unclear. The IRS has ruled that the state of Michigan's authority has tax liability on the investment yield as it is earned. Approximately $15 million was paid to the IRS while the decision was appealed. In a ruling this summer, the IRS position was upheld. Further appeals are pending.

If this ruling is upheld, it will be very difficult for any state, with restrictions on investment options, to achieve sufficient post-tax yields to offset both inflation and the tax liability of the parent or student. Financial feasibility calculations will be very difficult while this uncertainty exists.

The implications of changes to the current tax treatment of federal series EE bonds are also significant. Currently, parents may purchase series EE bonds for education expenses under certain conditions, including an income cap. Congress has proposed the elimination of the income cap. This would open this program up to many upper-middle income families. The yield on series EE bonds has traditionally exceeded non-taxable market rates. It might be difficult for the state to compete with federal government EE bonds, considering both yield rate and ease of purchase. Payroll deductions for series EE bonds are easy to initiate, modify or cancel, and are readily available.

WHAT ARE THE IMPLICATIONS FOR FINANCIAL AID? Some parents are concerned that participation in savers or pre-paid tuition programs will reduce their child's eligibility for need-based financial aid. In general, available assets will reduce the need for financial aid. Although changes have been proposed to the method used to determine eligibility for federal financial aid, the availability of a contract to pay tuition would reduce the student's need for both federal and Virginia financial aid. A few states with pre-paid tuition or college savers programs have decided to omit the resources from such programs in the determination of state aid awards.

Given the low level of funding for both federal and state financial aid, parents must recognize that the potential of financial aid in the future must be discounted by the probability that it will not be available in sufficient quantity to meet all expenses, or at all. At the very least, the state should attempt to inform parents of the risks involved of relying totally on financial aid. Even with aid packages that are described as meeting all need, families and students are expected to make some contribution toward cost, and the aid package usually includes loans along with amounts for grants, scholarships, or work-study jobs. That the family

must be prepared to make some investment is a message that needs to be communicated widely and often.

Any pre-paid tuition program must deal with this concern and policy if the program is to be attractive to a broad spectrum of families or have a significant effect on future demands for need-based aid.

WHAT ARE THE EDUCATIONAL ADVANTAGES OF HAVING A PRE-PAID TUITION PROGRAM? In addition to the potential fiscal advantage of having more resources available to students and their parents for the cost of education in the future, parents' and students' decisions will be influenced by the knowledge that they have already paid for college or advanced technical education. It is likely that more attention will be given to student academic achievement by parents since they have made a significant investment in the child's education.

Any increase in student achievement levels and in the number of students graduating with better preparation for either traditional collegiate programs or continuation of Tech-Prep education must be viewed as a positive change. Having better-prepared high school graduates will reduce the need for remedial education and could reduce the time required for students to obtain collegiate degrees. Higher education research indicates that there is a strong correlation between the academic achievement of entering students and improved retention and graduation rates.

Additionally, there may be improvements in high school retention and graduation rates if the concern about how to finance higher education is removed from consideration and a student's perception of educational goals is established by a parental decision at birth or soon thereafter. How a student views himself and his future has a strong influence on both academic and personal behavior. Combined with curricular changes associated with the new "World Class Education Initiative," dramatic changes in course offerings and student performance could be achieved.

ORGANIZATION OF REPORT

This report now focuses on the "Pay in Advance" options that are available to parents and the specific issues related to pre-paid tuition programs. Virginia already has a college saver program authorized. The role and future of the existing college savers program and the proposed pre-paid tuition program will be discussed in the following sections of the document, which

1. summarize the programs offered by the federal government and other states and examines the major issues related to such programs;

2. provide a status report on current financial aid programs available to Virginia's students;

3. describe the loan programs offered in Virginia;

4. estimate the potential demand for such a program in Virginia;

5. examine the assumptions about investment yields needed to support such a program; and

5. present recommendations for consideration by the Governor and General Assembly.

I. Current Methods of Financing College Education

With the rising costs of college expenses, the issue of financing has been raised to a level of concern commensurate with that of the ability to complete college work and with the determination of which school to choose. Currently, parents and others have available a variety of options that will enable them to fund a college education. Some state governments and the private sector have, in some manner or form, devised methods to aid people to prepare for these constantly increasing costs.

All programs involve future planning. Only a small group of citizens can afford to fund future college expenses out of current income. A complete understanding of the individual's financial status, the expected cost of education, and further analysis of tax considerations must be taken into account in order to determine which program maximizes the benefit to any one participant.

Federal Government

Section 135 of the Internal Revenue Code provides that interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, be excluded from gross income, if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year. Qualified higher education expenses are defined as tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible educational institution.

Currently, the exclusion by Section 135 is phased out for certain higher-income taxpayers. The year in which the savings bond is redeemed determines the taxpayer's adjusted gross income, not the year in which the savings bond was purchased. For taxpayers filing a joint return, the phase-out range for the adjusted gross income is between $60,000 and $90,000, while for single taxpayers and heads of households the phase-out range is between $40,000 and $55,000, both adjusted for inflation.

The interest exclusion is available only to taxpayers who are at least 24 years old. The interest rate on Series EE savings bonds varies, depending on how long the bonds are held. The interest rate on such bonds held for at least five years is based on the market rate for 5-year Treasury Notes. Bonds held for less than five years earn interest on a fixed, graduated scale

at below market rates. All interest is paid upon redemption.[4]

On July 29, 1992, the Senate Finance Committee approved Chairman Lloyd Bentsen's tax proposal which includes an expansion of the Series EE bond program for qualified higher education expenses. The proposal would expand the definition of qualified higher education expenses" to include any individual, not just dependents. It would also repeal all income and age limitations.

While such changes would make the Series EE bonds more attractive for more people, concerns have been raised by both the private sector and state governments. The greatest concern of the private sector is that the EE savings bond would have an unfair advantage over other savings and investment products. State governments point out that the total tax exemption of a U.S. government-issued debt instrument, paying taxable rates, may open the door for other special-purpose tax-free U.S. government debt that will ultimately compete with the issuance of state tax-exempt debt. However, the popular demand for savings bonds, the ease of purchase through payroll deductions, and the portability between states makes this a very attractive program.

Other possibilities which the federal government has analyzed and for which bills have been proposed in both houses of Congress include (a) special educational accounts, similar to Individual Retirement Accounts (IRAs) and (b) special educational incentives such as restoration of the tax deductibility for interest paid on educational loans and incentives. Further, proposals have been made for allowing penalty-free withdrawals of funds from an individual IRA in order to pay qualified educational expenses.

With President Bush's veto of the budget bill, the future of these policy changes is uncertain.

STATE GOVERNMENT

There are three types of programs that some states are offering:

a) College savings bonds
b) Pre-paid credit programs, and
c) Tuition prepayment plans

College Savings Bonds. These instruments are zero coupon bonds, sold at a given yield to be redeemed at maturity. Since they are zero coupons, principal and accumulated earnings are redeemed at par ($1,000). The difference between the cost and the redemption amount is tax free. However, it must be pointed out that in the event the holder sells the bonds prior to maturity, capital gains or losses may be realized that come under the capital gains tax law. Since these are municipal bonds issued by the states or their authorities, proceeds do not have

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[4]Professor David Williams, II, ***"Taxation of Pre-Paid Tuition Plans and Other Forms of College Expense Help"***, Institute for Higher Education Law and Governance, IHELG Monograph 92-3.

to be used for educational expenses. The instruments have several other drawbacks. First, the issue of suitability must be addressed. People who purchase these bonds should be in an income bracket that would benefit from tax exempt securities. The state would be morally obligated to assure that people in the lower income ranges not make use of these instruments. Further, the relatively low yields may make it difficult to match the rising cost of a college education over time.

The cost of issuing zero coupon bonds is higher than for coupon bonds, and since most zero coupons are not callable, they offer less flexibility in the management of the issuer's debt management program.

Virginia issued one offering of its College Savings Bonds in 1989. Adjustments were made to the structure of the offering to make it more attractive to institutional investors when the entire issue was not sold upon offering.

Pre-Paid Credit Programs. Under these programs, an individual may purchase college credits today, at a set price, to be used in the future. Under the Ohio plan, each tuition credit is worth 1% of the weighted average of the annual cost of tuition at the state's public universities and colleges at the time of redemption. The plan allows parents or other benefactors to purchase up to 400 tuition credits per beneficiary for use in the future. This allows one to lock in the cost of tuition for a child's future college education.[5] Purchasers may buy as few or as many credits as they wish and have no obligation to purchase a minimum amount.

The credit amount is set by the terms of the program. In most cases, it is established using the average or weighted average tuition and fees for public colleges in the state rather than setting the value equal to the actual cost of attending a specific institution. Parents or students assume responsibility for the difference between the credit amount and the actual tuition charges.

Tuition Prepayment Plans Under these programs, the purchaser, through single or installment payments, is guaranteed two or four years of college tuition at one of the state's colleges or universities. The Michigan Education Trust (MET) and Florida's Postsecondary Education Expense Program (FPEEP) are two examples of tuition prepayment plans.[6] Unlike the pre-paid credit program, the purchasers enter into a contract which commits them to pay, at a fixed price, for either a two- or four-year program. Obviously, flexibility exists that would enable the sponsor to offer one-year plans if marketing research found such an option to be attractive to the purchasers.

PRIVATE SECTOR

The private sector offers a large number of investment products that can be structured to match future college tuition costs.

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[5]Ibid.

[6]Ibid.

Insurance Companies: Annuities and cash value life insurance. While income on these vehicles does accrue tax deferred, the rates of return and tax consequences must be considered. Further, the fees are in many cases quite high and will be an offset to any earnings generated. However, a whole-life policy could provide protection if a parent dies, while allowing parents to borrow much of the accumulated cash value to pay tuition.

Direct Equity Mutual Funds: Over long time periods, the return on equities is higher than on any other asset group other than a number of esoteric investments. However, they are also one of the most volatile and cannot be depended upon to return a specific amount at a specific time in the future.

Direct Fixed Income and Money Market Mutual Funds: Depending on the quality of the fund and the maturity structure, fixed income securities return a predictable cash flow which is usually far more dependable than equities. However, the risk of not meeting one's objective, especially with short term funds, is quite high.

Banks: Banks offer a variety of investment products. They may range from certificates of deposit and various mutual funds to individual securities brokerage services.

Investment Banking Firms: As is the case with banks, a large variety of products is offered. While the broker's primary function or role is still advice and execution of individual securities trades, packaged investments ranging from certificates of deposits to annuities and real estate investment funds are available.

TAX IMPLICATION OF SAVINGS METHOD.

The various types of taxation issues that may be applicable when engaging in a savings program for college tuition and fees must be carefully analyzed.

Series EE Savings Bonds The current Savings Bond program for college tuition is quite restrictive. First, the bonds eligible for this special treatment are only those that were issued after December 31, 1989. Second, the only expenses that fit under the provision are those expenses that are qualified higher education expenses. The payment of room and board is noticeably omitted. Also, grandparents, an important group looked to for funding college expenses, would not be afforded the tax-free benefit.[7]

Additionally, under the current structure, the tax-free gain on redemption will apply only if, at the time of redemption, the taxpayer meets certain adjusted gross income requirements. The interest income exclusion could be phased out for taxpayers with adjusted gross income above certain levels, as discussed earlier.

In the event the proposed expansion of the Series EE bond program for qualified higher education expenses is enacted into law, most of the concerns discussed above would be resolved.

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[7]Ibid.

College Savings Bonds: As was pointed out above, these are tax-exempt bonds and earnings are free of federal and local taxes. However, capital gains and losses may have to be reported upon sale prior to maturity.

Pre-Paid Credit Program: There may be at least three hidden tax concerns in this type of program.

> First, upon the purchase of the credit by the parent for the child, there is the possibility of the gift tax being triggered. Since it may be looked upon to be a gift of a future interest, the annual $10,000 exclusion may not be available. Legal arguments exist, however, that would leave the exclusion in place.
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> The second hidden tax may occur when the individual redeems the tuition credit. In essence, the difference between the cost of the credit and the value at redemption is taxable to the redeemer. While legislation may be introduced in the future to exclude this amount from gross income, presently this amount is clearly taxable, and the states that sponsor this type of plan have accepted that conclusion.
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> The third concern involves the tax consequences of the investment earnings of the authority sponsoring the program. This would decrease the return capabilities and increase the purchase price of the credits. The sponsoring authorities take the position that the income earned on their investment should be exempt from tax under Section 115 of the Internal Revenue Code, since such income is derived by their performance of an essential governmental function, which accrues to the benefit of the state. Section 115 of the tax code states that "gross income does not include income derived from any public utility in the exercise of any essential governmental function and accruing to a state or any political subdivision thereof ....". In addition, the authorities have made the argument that the income earned on the investments should be exempt from federal taxation pursuant to the Doctrine of Intergovernmental Tax Immunity, since the authorities are a state instrumentality. The Ohio Tuition Trust Authority requested the Internal Revenue Service to rule on these points, but the service has not yet officially replied.[8]

Tuition Prepayment Plans: Before selling its first MET contract, the Michigan Authority was required to obtain a ruling from the IRS stating that during the administration of the program, the income earned by the Authority would not be taxed to the purchaser or the beneficiary. While the requested ruling did exempt the purchaser or beneficiary from taxable income during the period of administration, other taxable events were exposed and the issues of the gift tax, when educational services are received, could exist here as well and must be addressed.

However, the question of the income of the Authority's trust has created the most attention. In the ruling requested by the Michigan Authority, the Authority argued that the

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[8]Ibid.

income earned by the Trust was the equivalent of the income being earned by the state. Further, the income was derived from the exercise of an essential governmental function and should be excluded from gross income under Section 115 of the Code. The service ruled that in the case of Michigan, the Trust was not an integral part of the State of Michigan or one of its political subdivisions. It also ruled that the service was more than incidental to the public welfare and, therefore, failed the Section 115 test. The Trust and the State have filed suit in the United States District Court, Western District of Michigan.[9]

On July 28, 1992, the United States District Court issued an order that the motion for summary judgment filed by the State of Michigan and the Michigan Education Trust be denied. The possibility of an appeal is high.

Inventory of Programs Offered by Other States

A survey conducted in February 1992 indicates that only seven states do not offer any type of college tuition assistance program. While the majority of programs involves some kind of College Savings Bonds program, at least eight states either have in place or are planning a pre-paid credit program or a tuition prepayment plan.

Alabama

The Wallace-Folsom Prepaid College Tuition Trust Fund is marketed as the Alabama P.A.C.T. of Prepaid Affordable College Tuition. Legislation unanimously passed both houses of the state legislature in 1989. An Alabama P.A.C.T. contract guarantees the payment of up to four years of undergraduate tuition and mandatory fees at any two- or four-year college and university. The program is administered by the State Treasurer under the guidance of a ten-member board of trustees. The program is open for enrollment during May. During 1990 and 1991, about 20,000 contracts were purchased.[10]

Alaska

The Alaska Advance College Tuition (ACT) plan was effective on April 1, 1991. The legislation creating the Advance College Tuition Payment Fund allowed the use of "permanent fund dividends" or cash contributions to secure tuition credits at today's cost for use in the future. The "permanent fund dividend" is a program that allows qualified Alaska residents to share in the revenues the state receives from oil and gas royalties. The Alaska ACT permits a check off of 50 percent on the permanent fund dividend application to purchase tuition credits. The tuition credits go up in price each year, which is different from the guaranteed prepayment plan approach, which offers a fixed price for the purchase of a set amount of credit hours. In 1991 approximately 1.29% of the residents of the state (6,800) elected to have half of their

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[9]Ibid.

[10]Ibid.

permanent fund dividend (approximately $500) paid into the Prepaid Tuition Program.[11]

Florida

The Florida Prepaid College Program, with 125,000 contracts as of April 30, 1992, is the largest prepayment plan in the United States. Contracts were first accepted in September 1988. During four enrollment periods (approximately three months each fall) over 178,000 prepaid college contracts have been purchased. Over 125,000 prepaid tuition and 34,000 dormitory contracts are currently active with a cancellation rate of less than ten percent. The market value of the trust fund is approximately $250 million as of April 30, 1992. The Florida Prepaid College Program offers three different tuition plans and five dormitory options with three different payment methods. The payments are guaranteed by the state of Florida to be made at the time of matriculation of the beneficiary in the Prepaid College Contract.[12]

Initial appropriation was $600,000; the payback period was two years. The system currently has an in-house staff of seven full time employees, with supplemental temporary help during enrollment season; the annual budget is $1,000,000. All major services and administration are provided by outside vendors. Funds are invested in both equities and fixed income securities. Contracts are backed by the full faith and credit of the state.

Kentucky

The Kentucky Educational Savings Plan Trust (KESPT) was created by the 1988 General Assembly to inform parents and other benefactors of the expected future costs of postsecondary education and to offer a savings plan to help families prepare for projected higher education expenses. The KESPT is administered by the Kentucky Higher Education Assistance Authority (KHEAA), an agency of the Commonwealth of Kentucky. The KESPT is neither a prepaid tuition credit nor a prepaid college plan, but rather offers competitive savings rates. Investment earnings are free of Kentucky taxes, and monies are to be applied toward tuition, fees, room, board, books, supplies, and other educational expenses at any two- or four-year public, regionally-accredited private or nonprofit college of university, or vocational-technical school in the United States. Additionally, beneficiaries attending Kentucky institutions will be entitled to a financial bonus from the Endowment Trust. There are 983 participants, and Program Fund savings have exceeded $1,000,000.[13]

Michigan

The Michigan Education Trust (MET) first offered guaranteed prepayment contracts in September 1988. During this first enrollment period, over 40,000 contracts were purchased.

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[11]William Montjoy, ***"State Tuition Prepayment Programs"***, NAST, College Savings Plans Network-Organizational Meeting, April 14-15, 1992.

[12]Ibid.

[13]Ibid.

An additional 10,000 contracts were purchased in the second enrollment period in fall 1989. In fall 1990, MET offered an installment payment option for the first time, and approximately 5,000 additional contracts were purchased. The MET trust fund has a current market value in excess of $350 million. The contract covers tuition and mandatory fees at any of the public post-secondary institutions.[14]

Ohio

The Ohio Tuition Trust Authority (OTTA) has been selling prepaid tuition credits since December 15, 1989. Unlike the prepaid contract programs of Michigan, Florida, and Alabama, Ohio offers tuition credits. Alaska used this program as its model. The price of a tuition credit is adjusted annually on November 30, with each tuition credit worth approximately one percent of the weighted average of the annual cost of tuition for Ohio's public universities and colleges. The plan allows parents or other benefactors to purchase up to 400 tuition credits for use by beneficiaries at the time of their future college enrollment. Approximately 25,000 children have been enrolled in the program, with a trust fund market value of approximately $40 million.[15]

Initial appropriation was $1,091,000; the pay-back period was two years. The system currently has an in-house staff of fifteen full-time employees, supplemented by temporary help when needed. The annual operating budget is $1.4 million. The program is administered entirely in-house. The Ohio Public Employees Retirement System invests funds on behalf of the authority.

Pennsylvania

Pennsylvania is currently preparing to implement a prepaid tuition program.

Virginia

Virginia implemented a College Savers Program in 1988. In June 1989 Virginia College Savings Bonds were issued through the Treasury Board as 9(C) general obligation bonds of the Commonwealth to finance certain revenue producing capital projects at institutions of higher education and the widening of the Dulles Toll Road in Northern Virginia. The bonds were issued in two series: $42 million for higher education projects, of which $24.7 million were designated College Savings Bonds; and $34.3 million for the Dulles Toll Road, of which $21.2 million were designated College Savings Bonds.

No offerings have been made since the 1989 issue.

Wyoming

Wyoming's prepaid program was signed into law in February 1987 and contracts went

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[14]Ibid.

[15]Ibid.

on sale in August 1987. A Wyoming Prepaid College Contract includes tuition and room and board in one comprehensive package, unlike other states' programs. The only university in the state participating in the program is the University of Wyoming. The plan is not transferrable to other universities or other states.

Benefits under the Wyoming prepayment plan may be used no sooner than ten years after payment is first received and no later than 17 years after receipt of first payment. The program is administered by the Deputy Treasurer of the University of Wyoming Board of Trustees, and the funds are invested in a commingled pool with other University of Wyoming investments. Less than 1,000 prepayment contracts have been purchased since inception of the program.[16]

II. Financial Aid In Virginia

There are many Federal and state financial aid programs currently available to college students at both Virginia's public and private colleges. Grant programs are provided to eligible students based on demonstrated financial need, academic merit, resident status, and other criteria. Loans are available either to supplement grants or to assist students who don't qualify for a grant. Work-study programs allow students to earn money to contribute to their educational expenses.

Calculation of Financial Need

A student's eligibility for federal and state financial aid is calculated using a formula mandated by Congress called the "Congressional Methodology." In order to determine eligibility, each student must complete a financial aid request form, which includes information on family income, assets, liabilities, and current expenditures. A determination is made about how much the family can afford to contribute to educational expenses. This amount is compared to the cost of attending college to determine how much aid the student qualifies for.

An important factor in determining need is whether the student is classified as a dependent or independent student. Dependent students are expected to receive support from their parents while independent students are considered for aid based on their own financial status. Other factors in determining eligibility include students' citizenship status, whether students are enrolled in a degree or certificate program, and whether they attend school on a full or part-time basis.

For the purposes of the state discretionary aid program, financial need is derived from a simple formula similar to the "Congressional Methodology," using total cost, expected family contributions, and existing forms of financial aid. The framework for determining need at the state level is outlined in the following chart. The calculation is performed on every student record on the data base. The sum of the results of these calculations is the statewide need for financial aid.

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[16]Ibid.

TOTAL COST (Tuition, Room and Board, Books, Transportation Supplies, Personal Expenses)	
Less:	Expected Family Contribution
Less:	Grants and Scholarships
Less:	Work Study
Less:	Loans (optional)
Equals:	Remaining Need
Adjusted For:	Tuition and Fee Cap
FINAL ADJUSTED NEED	

Total cost includes actual tuition and fees, room and board charges, and standard costs for books, transportation, and personal expenses. The **expected family contribution** is calculated through the federal needs-analysis form. It is based on a combination of factors including family income and other assets, number of dependents, and unusual family expenses. Totals for **grants and scholarships**, **work-study**, and **loans** reflect the total amount of those types of aid received by the individual student. A student's **remaining need** is calculated in two ways: including loans and excluding loans. Finally, the remaining need is capped at the amount of tuition and fees at the institution. The tuition and fee cap, in essence, limits the amount of financial need to tuition and required fees only. The result of this last adjustment is a student's **final adjusted need**. This is the amount of financial assistance the student needs in order to pay tuition and required fees.

In enacting the Reauthorization of the Higher Education Act, several changes were made to the Congressional Methodology or the application form. Families with incomes under $50,000 are now able to use the short form, which will make it easier for them to apply and should increase the number of students applying.

Farm and home equity is now excluded from the calculation of family contribution, which also will increase the number of applicants, especially middle-income students, and decrease the family contribution amount, which in turn, will increase the amount of need. Because there has not been a comparable increase in the funding of the federal programs, the amount per student will probably decrease because of the increase in applicants and overall enrollment growth.

Finally, there was a change in the classification of students as independent from their parents. Students under age 24 must prove financial independence from their parents, especially if they are not married.

Federal Financial Aid Programs

Federal financial aid programs available at Virginia's colleges and universities include two grant programs, four loan programs, and a work-study program. The amount and structure of these awards vary from program to program and from year to year based on federal

appropriations to these programs. The following is a summary of each program.

Pell Grant:

Pell Grants are available to undergraduate students enrolled at least half-time who demonstrate extreme financial need. Unlike a loan, the grant does not have to be repaid. A grant is awarded to every eligible student. The amount of a Pell Grant is calculated by dividing the total program funding allotted by the U.S. government by the number of eligible recipients.

Supplemental Educational Opportunity Grant (SEOG):

SEOGs are awarded to undergraduate students who demonstrate exceptional financial need. Priority is given to Pell Grant recipients. Unlike the Pell Grant program, which is administered by the federal government, SEOGs are campus-based and are administered by the financial aid offices of participating institutions. The amount of a SEOG varies each year, depending on the student's financial need and the amount of money allocated to the institution.

College Work Study:

College Work Study (CWS) is a campus-based program which allows students to earn money to contribute to their educational expenses. Students may work at on or off campus jobs, depending on the sites available through the financial aid office. Undergraduate and graduate students enrolled at eligible institutions may participate in CWS. The amount of CWS that a student receives varies according to financial need, the student's hourly wage, and the number of hours worked. The school and the student determine the student's work schedule based on the amount of the CWS award and the student's class schedule and academic standing.

Stafford Loans:

Stafford Loans are federally subsidized, low-interest education loans made by banks, credit unions, and savings and loans. These loans are based on financial need and must be repaid. Undergraduate and graduate students enrolled at least half-time may participate. In many cases, Stafford Loans are supplemental to Pell Grants when Pell Grants do not cover the full cost of a student's education. Eligible students may borrow up to $2,265 per year for first or second-year undergraduates, $4,000 per year for juniors and seniors, and $7,500 per year for graduate students. Students are not allowed to borrow more than the cost of education at the school minus any other financial aid they receive. The total debt allowed under the program may not exceed $17,250 for undergraduates and $54,750 of graduate students (including undergraduate loans). In most instances, payment of a Stafford Loan begins six months after the student graduates, leaves school, or drops below half-time status. The amount of each payment is determined by the size of the debt and the length of the repayment period, which can extend up to 10 years. The minimum payment for this loan is $50 per month.

Parent Loans (PLUS) and Supplemental Loans for Students (SLS)

These are two educational loan programs which are not based on financial need. The loans are made by banks, credit unions and savings and loans. PLUS loans are available to parents of dependent undergraduate or graduate/professional students, and SLS loans are available to independent undergraduate and graduate/professional students. SLS borrowers are eligible to receive up to $4,000 per year; PLUS borrowers may receive up to $4,000 per student per year. The total debt under the programs may not exceed $20,000 for each student. Borrowers may not receive more than the cost of education less other aid.

Perkins Loans:

A Perkins Loan is a low-interest loan made through a school's financial aid office. The loans are available to undergraduate and graduate students who demonstrate some financial need. The school acts as the lender; each school receives an allocation of funds form the federal government. The money is awarded on a first-come, first-served basis. Freshmen and sophomores may borrow up to $4,500, juniors and seniors up to $9,000 and graduate/professional students up to $18,000. Repayment of the loan begins 9 months after the student graduates, leaves school, or leaves to half-time status. The repayment period may extend for a maximum of ten years.

VIRGINIA FINANCIAL AID PROGRAMS

The state financial aid programs provide grant and loan programs to afford access to a college education for needy students, scholarships and fellowships based on merit or service, and a state work-study program to allow students to earn money to contribute toward their educational expenses. These programs are used to augment the federal programs in order to provide coverage for students who are needy but do not receive financial aid and to address specific needs for Virginians. Some of the largest state programs include the following.

Virginia College Scholarship Assistance Program (CSAP):

CSAP awards grants to undergraduate students who demonstrate financial need. The amount of the award ranges from $400 to $2,000.

Virginia Scholars Program (VSP):

VSP is a merit-based scholarship program designed to encourage Virginia's brightest high school and two-year college students to attend college in Virginia. The award amount for 1991-92 is $3,000 per year.

Virginia Tuition Assistance Grant Program (TAG):

TAG is available to undergraduate and graduate/professional students who are residents of Virginia and enrolled at eligible private colleges and universities in Virginia. There

is no financial need requirement for this grant. The amount of the TAG grant is based on the amount of funding provided divided by the number of eligible students. The amount of the grants has ranged from $1,300 to $1,500 per student over the past few years.

Virginia Transfer Grant Program (VTGP):

VTGP awards grants to "other race" students who are enrolled in a four-year Virginia public college or university. Applicants must meet minimum merit criteria and qualify for entry as first-time transfer students. The grant provides full tuition and mandatory fees or remaining need, whichever is lower.

Virginia Work-Study Program:

This program allows undergraduate and graduate students to earn money to contribute toward education expenses. The amount of the award varies with the hourly wage and the number of hours worked.

Last Dollar Program:

The Last Dollar Program awards grants to "other race" undergraduate students enrolled for the first time in a state supported college or university in Virginia. Financial need must be demonstrated.

Paul Douglas Teacher Scholarship:

Designed to encourage outstanding high school graduates to pursue teaching careers, this program awards scholarships on a competitive basis to qualified Virginia residents who rank in the top ten percent of their high school graduating class. Applicants must enroll for full-time study in a program which leads to teacher certification at an eligible Virginia four-year college or university. The maximum award for 1991-92 is $5,000.

Discretionary Aid Program:

With an appropriation of $37.4 million in 1992-93, this is the largest state-supported grant program. Funds are appropriated to each institution to provide aid to both graduate and undergraduate students. The grants to undergraduate students are restricted to in-state students who have demonstrated financial need. Individual awards cannot exceed the amount of tuition and fees. These grants are available to part-time students enrolled in a minimum of six credit hours per semester.

There are many other financial aid programs available at Virginia's colleges and universities. They include:

- Nursing Scholarship Program
- Medical Scholarship Program
- Rural Dental Scholarships

- Virginia Teaching Scholarships
- Traineeship for Special Education Personnel
- State Law Enforcement Officers Educational Program
- State Cadetships
- Virginia National Guard
- Virginia World War Orphan Education Act
- Soil Scientist Program
- Senior Citizens Tuition Waiver

Another source of financial aid are the unfunded scholarships that are provided by some institutions from revenue sources other than direct federal or state appropriations. These are primarily need-based scholarships provided to Virginia students.

The 1992 session of the General Assembly created a new grant program to start in 1994 entitled the Virginia Guaranteed Assistance Program. Students must demonstrate financial need, live in Virginia, achieve a secondary school grade point average of 2.5, and certify that they have been not convicted of any criminal offense. The grants will be awarded on a yearly basis; to be eligible for renewal a student must show satisfactory academic progress. Beginning in 1992-93, institutions will be allowed to give state student aid funds to part-time students.

Financial Aid Appropriations

During the 1980s, financial aid appropriations did not keep pace with tuition increases. Between 1980 and 1988, tuition and fees increased by 162% while state financial aid appropriations increased by just 60%. The need for financial aid during this period was mitigated somewhat by the strong economy in the state reflected in substantial increases in per capita income.

However, the recent economic downturn has renewed the focus on the availability of financial aid programs. The 1992 session of the General Assembly took action to address access to higher education for needy students. The Assembly appropriated an additional $24.1 in student financial aid for a total of $81.4 million for the 1992-94 biennium. This unprecedented increase will allow many more students to be helped; however, due to tuition increases averaging 15% for undergraduates in 1992-93, it is estimated that only 45% of the financial aid need will be met.

III. Loan Programs In Virginia
Education Finance Through Borrowing

The largest component of student financial aid for funding the expenses of post-secondary education has become student loans. There are three federal loan programs and one supplemental program currently available to Virginians.

Federal Stafford Loans

Stafford loans are federally sponsored, low interest education loans made by banks,

savings and loans and credit unions. Beginning October 1, 1992, there will be two types of Stafford loans: subsidized and unsubsidized. Subsided loans are awarded based on financial need, and the federal government pays the interest on these loans during the period the student is in school or under any approved periods of deferment.

Unsubsidized Stafford loans are available to those that do not qualify for subsidized Stafford and are different in that the borrower is responsible for paying the interest on the loan while he is in school or during any authorized period of deferment. This interest may be capitalized, meaning added to the principal and paid after the student leaves school. The school determines eligibility for each type of Stafford loan. Some students eligible for only a portion of the loan limit on a subsidized Stafford may borrow the rest under an unsubsidized Stafford. Both types of Stafford loans charge a variable interest rate of the 91 day Treasury Bill plus 3.1%, with a maximum rate of 9%. The rate changes every July. Loan limits for Stafford loans for undergraduate programs of at least one year and graduate programs are as follows.

Student Status	Unit July 1, 1993		After July 1, 1992	
	Max Per Year	Aggregate	Max Per Year	Aggregate*
Freshman	$2,625	$17,250	$2,625	$23,000
Sophomore	$2,625	$17,250	$3,500	$23,000
Junior	$4,000	$17,250	$5,500	$23,000
Senior	$4,000	$17,250	$5,500	$23,000
5th Year	$4,000	$17,500	$5,500	$23,000
Graduate	$7,500	$54,750	$8,500	$65,500+

* Maximum aggregate includes the student's undergraduate Supplemental Loans for Students (SLS).
+ Graduate Stafford rates change for loan periods beginning after October 1, 1993.

Repayment on Stafford loans begins six months after the student graduates or otherwise leaves school and may last up to ten years. The unsubsidized Stafford begins repayment after disbursement, and interest begins to accrue immediately. As a practical matter, most students obtaining an unsubsidized Stafford are expected to defer principal while in school and have the interest capitalized so that no payments are required while in school, causing the unsubsidized Stafford to resemble its subsidized counterpart.

Until recently the Stafford borrower was generally an undergraduate, dependent student from a household income of less than $35,000. The introduction of the unsubsidized Stafford, combined with changes in the way need is calculated for subsidized Stafford, will open eligibility to all full-time students for some form of Stafford loan.

Federal SLS Loans

The Federal Supplemental Loan for Students (SLS) is a long term loan available to undergraduate, graduate and professional students. Students must first have their eligibility calculated for a Pell grant and a Stafford loan before they can be awarded an SLS. For the most

part SLS loans are made to independent students.

SLS loans charge a variable interest rate of the 52 week Treasury Bill plus 3.1%, with a maximum rate of 11%. The rate changes every July.

Students may borrow as follows:

Student Status	Until July 1, 1993		After July 1, 1993	
	Maximum	Aggregate	Maximum	Aggregate
Freshman	$4,000	$20,000	$4,000	$23,000
Sophomore	$4,000	$20,000	$4,000	$23,000
Junior	$4,000	$20,000	$5,000	$23,000
Senior	$4,000	$20,000	$5,000	$23,000
5th Year	$4,000	$20,000	$5,000	$23,000
Graduate	$7,500	$54,750	$8,500	$73,000

Repayment of SLS begins immediately after the funds are disbursed and may last up to ten years. However, students may defer the principal during school and capitalize the interest so no payments are made during school.

Most SLS borrowers are independent students and often are returning adults. While SLS is not technically a need based student loan, most borrowers tend to come from lower income households. SLS also tends to have a higher number of graduate school borrowers than Stafford.

Federal PLUS Loans

The Federal PLUS Loan is a long term loan to parents of dependent undergraduate and graduate students and may be used in conjunction with Stafford.

The interest rate on PLUS is variable and calculated as the 52 week Treasury bill plus 3.1%, with a cap of 10%. The rate changes every July.

Until recently, parents were able to borrow up to $4,000 per academic year per student with an aggregate maximum of $20,000. Beginning with loans disbursed after July 1, 1993, parents will be able to borrow up to the cost of education less other aid. For parents of students qualifying for no aid this could be the entire cost of education, which includes tuition, room, board, fees, books and other expenses such as transportation. At some schools in Virginia this amount is over $20,000 per year.

Repayment on PLUS loans begins immediately after disbursement and may last up to ten years.

PLUS loan borrowers typically come from middle income households. Until recently PLUS was not a high-volume loan product in Virginia because the schools did not promote PLUS borrowing and there was not exceptional need. With increased tuition and the general economic environment, however, PLUS borrowing has grown dramatically in the last two years.

Edvantage Loan Program

Edvantage is Virginia's supplemental loan program that was introduced in 1988 to provide an alternative for parents and students that did not qualify for federal need based loans. Edvantage is credit based, meaning the loan is made based on the ability to repay (income less other obligations) and the borrower's propensity to repay (credit history). Most borrowers tend to be parents, but the student is always a co-borrower on an Edvantage loan, allowing the student to assume the payments after he or she graduates.

Edvantage loans are available for up to $15,000 per year per student for a maximum aggregate borrowing of $60,000 per student. The interest rate is prime plus 1 1/2%, which changes monthly.

Payment on Edvantage loans begins immediately after disbursement and may last up to 15 years. Borrowers may defer principal while the student is in school but must at least make periodic interest payments.

The average Edvantage borrower has household income of $60,000 and is normally a parent of a dependent, undergraduate student.

Volumes for the various loan programs by school type for state fiscal year end 1992 are found in Exhibit A.

Changes on the Horizon

Projections are for a general increase in demand for higher education over the next 15 to 20 years. The number of high school graduates will steadily increase as the baby boomers' children graduate from high school. More and more of these graduates are expected to see college as the key to a higher standard of living as labor projections show job growth in professions requiring at least some post-secondary education.

Also, the number of returning adults is expected to continue to grow as workers return to school for more marketable degrees, to complete degrees never finished, or for retraining.

This surge in demand, combined with rising tuition and reduced grant funding, will cause borrowing to increase. The recent reauthorization of the higher education act also puts into place several changes that will fuel increased borrowing:

1. Changes in the formula used to calculate need for Stafford loans will increase the threshold of household income at which students qualify. By removing home and farm equity from the equation, families are expected to qualify at incomes up to $50,000 rather than the current $35,000.

2. The unsubsidized Stafford loan will be available to those not qualifying for subsidized Stafford, allowing thousands of middle and upper middle income students to borrow.

These two changes are expected to result in an additional 20,000 Stafford loans per year in Virginia.

3. Loan limits are increased in virtually every category from 13 to 37% starting in 1993, allowing for higher total borrowing.

Note: The results of the increase in PLUS, where the loan limit has effectively been increased upwards of 400%, are unknown at this point and may actually restrict lending in the PLUS program. The dramatic increase in the limit, combined with what appear to be restrictions on lenders' ability to conduct credit analysis on applicants, may actually restrict PLUS borrowing as lenders reevaluate their policies and participation in PLUS. Additional clarification from the U.S. Department of Education has been requested as to lender's ability to decline PLUS loans due to insufficient income or previous credit history.

For families with children in high school and even junior high, it is too late to begin a savings program that most can afford. Borrowing will likely be the answer to meeting the costs of higher education for most of these families. The changes in reauthorization will make that borrowing possible, but many will leave school with indebtedness of $10,000 to $20,000, and some as high as $30,000 or even $50,000+. Such debt levels actually reduce graduates' ability to establish households and contribute to the economy, causing some to question the cost compared to the benefits of college. Even now, many families are finding their college of choice is out of reach and are looking to creative solutions. Some students are living at home and commuting to the local university or attending a community college then transferring.

For families with younger children, savings programs will be needed to fund the cost of higher education and to supplement borrowing. The average family will not have the disposable income to save the entire amount needed every month to ensure they can afford the cost of a four year degree as the price soars into the $70,000, $80,000 or $100,000+ range. More likely, those with savings will pull from other sources, including borrowing and payment plans, while those that did not save may be shut out of the traditional college experience.

IV. Demand For A Pre-Paid Tuition Program In Virginia

Without resolution of the federal tax issues, it is not possible to make a realistic estimate of the potential demand for a pre-paid tuition program in Virginia. However, some estimates can be offered that might provide some insight to the potential interest in such a program or in the renewed availability of the college savers program.

Programs designed to increase public school retention and graduation rates will tend to increase the potential market for college savers and pre-paid tuition programs. Virginia's World Class Education Program should increase the number of students interested in and prepared to participate in either a traditional college experience or the advanced component of a Tech-Prep program. Changes in curricular decisions are difficult to consider in population ratio estimates

and will not be included in this analysis. Such policy decisions should be included in the typical market analysis of potential sales that must be conducted before any decision to implement a pre-paid tuition program is made.

One approach to estimating the potential demand is to examine the current funding for need-based aid in Virginia and the amount of outstanding, or unmet, need of enrolled students. A second approach is to use the participation rates in other states as a ratio to population, school population, high school graduates, or even college enrollments and apply the ratios to Virginia's data.

These approaches should be viewed with extreme caution, since they are not intended to replace the targeted marketing analysis that would be needed before making any final decision on implementing a pre-paid tuition program. Interest in the Virginia College Savers Program should also be examined because Virginia enjoys a very high rating on its debt, and experiences in less favorably rated states might not be applicable to Virginia.

Estimates Based on Current Undergraduate Student Financial Aid.

In 1991, the Council staff conducted a study of financial aid program utilization in Virginia in preparation for the 1992-94 biennial budget. The study focused on the amount of aid received from both federal and state sources, and whom it benefitted.

Over 43,000 Virginia undergraduate students, or about one-fifth of the total, received nearly $135 million in all forms of financial aid in 1989-90. The sources of aid included state appropriations, federal grants, institutional tuition waivers, academic scholarships, student work programs, guaranteed student loans, and other loans made directly to students. Not reflected in the data were loans to parents to pay for their children's education and other forms of aid, such as private bank loans, earnings from summer jobs, and gifts from grandparents.

Of the $135 million, $72 million was gift aid -- grants and scholarships that do not require repayment or work. The two largest sources of grants were the Pell grant program and the state discretionary aid program. Undergraduate students earned another $7 million through federal, state, and institutional work-study programs. Finally, students borrowed at least $55 million to cover their total costs. The largest loan program was the federal Stafford loan program. The table below shows the distribution of aid by the three primary aid categories.

Type and Amount of Financial Aid, 1989-90

Type of Award	Students	Total Dollars	% of Total	Avg Award
Grants and Scholar.	37,635	72,461,360	53.8%	1,925
Work-Study	6,716	7,159,692	5.3%	1,066
Loans	22,283	55,111,003	40.9%	2,473
Total	43,630	134,732,055	100.0%	3,088

NOTE: Students commonly receive more than one type of award in a financial aid package. Consequently, the totals for number of students and average awards do not equal the sum of their parts.

The Council staff also looked at the distribution of financial aid by family income levels. This review is important because of the state's long-standing commitment to access and in light of initiatives to guarantee financial access to lower-income, disadvantaged students who achieve certain academic goals. It is important also because of concerns that middle-income students are being squeezed by higher tuition and fewer opportunities for financial aid. The following table shows the distribution of student aid by family income group.

Distribution of Financial Aid, By Income Group, 1989-90

Family Income	Students	Total Dollars	% of Total	Avg Award
0-10,000	18,391	59,916,107	44.5%	3,258
10,000-20,000	8,624	27,203,818	20.2%	3,154
20,000-30,000	6,921	21,140,309	15.7%	3,055
30,000-40,000	4,673	13,553,580	10.0%	2,900
40,000-50,000	2,688	6,993,250	5.2%	2,602
50,000-60,000	1,278	3,287,332	2.4%	2,572
Over 60,000	1,055	2,637,659	2.0%	2,500
Total	43,630	134,732,055	100.0%	3,088

Not surprisingly, the majority of financial aid -- over $87 million -- went to students with the greatest need: those whose families earned less than $20,000 a year. A relatively small %age of the total funds went to students whose families were in higher income brackets. Since financial aid is based on need rather than income, it is possible for a higher-income student to receive financial aid. For instance, a student from a higher-income family with three children in college may be eligible for need-based financial aid.

The distribution of financial aid among income groups differs for each individual financial aid program according to the program's eligibility criteria and other factors. On average, though, students with lower family income received higher financial aid awards, as the following table shows.

Average Awards, By Family Income

Family Income	Grants and Scholarships	Work-Study	Loans
0-10,000	2,044	1,146	2,664
10,000-20,000	2,058	1,081	2,358
20,000-30,000	1,794	1,028	2,344
30,000-40,000	1,608	960	2,299
40,000-50,000	1,478	991	2,283
50,000-60,000	1,497	966	2,458
Over 60,000	1,639	888	2,829
Total	1,925	1,066	2,473

Because of the close relationship between income and need, the distribution of aid followed expected patterns: students from lower-income families received larger average awards than students from higher-income families. This pattern was most evident in grant and scholarship programs, in which a student whose family income was below $20,000 received an average award of $2,046 versus $1,680 for all others, a 22 % difference. (The reason the difference is not greater is because only students with identified financial need are included in the data. Many students at higher incomes are ineligible for need-based financial need and, consequently, are excluded from the calculations of averages.)

The breakdown among income groups was less distinct with loans. Students whose families earned less than $20,000 received an average loan of $2,567, just $200 higher than the average loan to all other students. It appears that, on average, a student's family financial situation is only a minor determinant in the size of a student loan in her or his financial aid package.

The Discretionary Student Aid Program

The largest state-supported grant program is the discretionary student aid program. The purpose of the discretionary aid program is to make Virginia higher education accessible to every qualified student. The General Assembly appropriates money from the general fund directly to the colleges and universities to support this program. At the undergraduate level, awards are restricted to in-state students who have demonstrated financial need. An individual award cannot exceed the amount of tuition and fees at the institution. In 1989-90, about $13.4 million went to undergraduate students. The 1991-92 appropriation is $23 million. The following table shows the distribution of state discretionary aid by income level in 1989-90.

Distribution of State Discretionary Aid, By Family Income

Family Income	Students	Total Dollars	% of Total	Avg Award
0-10,000	3,787	4,324,405	32.3%	1,142
10,000-20,000	2,193	2,664,075	19.9%	1,215
20,000-30,000	2,414	2,895,958	21.7%	1,200
30,000-40,000	1,823	2,149,572	16.1%	1,179
40,000-50,000	817	911,857	6.8%	1,116
50,000-60,000	279	307,815	2.3%	1,103
Over 60,000	110	120,157	0.9%	1,092
Total	11,423	13,373,839	100.0%	1,171

Although a large portion of financial aid expenditures benefit the lowest income students, there are significant awards to middle-income students as well. There is a gap, however, between what a middle-income family can reasonably expect to save for college costs and the total cost of attending college. Recent changes in federal programs are designed to close that gap and provide more aid for middle-income families and students. However, without a significant increase in the size of federal appropriations, being eligible for aid and actually receiving it will continue to be different realities.

Using the profile of aid recipients in 1990, it is likely that between 25,000 and 35,000 students per year will continue to have to rely on additional family contributions or loans to finance educational costs. These are potential consumers of a renewed college savers program or a pre-paid tuition program. This estimate should be increased because of the projected enrollment growth of approximately 65,000 additional students by 2001.

Population Ratio Estimates Based on Experience in Other States.

The experience in other states indicates that there is high interest in savers or pre-paid tuition programs when they are first made available, with a decline after one or two years. There are significant differences among the states, especially in conditions and frequency of availability, that must be considered. Some states discontinued sales while questions of tax liability were being resolved. Other states have responded to the current financial market and inflationary increases in tuition rates with much higher purchase prices. Both policies will have an effect on the volume of sales.

When a new program is offered, it is generally available to all children except those within one or two years of college enrollment. Initial sales tend to be spread across the age spectrum, while sales in subsequent years might be more concentrated on younger children. After a period of time, new sales should tend to follow demographic trends unless there are changes in college participation rates or changes in behavior from advertisements or other promotional programs.

In each state the initial year of operation generated the highest volume of sales. This can be attributed to pent-up demand for this type of program and because of widespread media coverage of a new program. All of the states have experienced a significant decline in sales after the first year and have tended to stabilize at approximately 1% of the total public school enrollment. It is important to note that Michigan suspended contract sales in 1991 pending a ruling in the tax liability litigation.

Prepaid Tuition Programs Participation Rates By State

State	Year	Public School Enrollment	Number of Contracts	Percent of P/S Enroll
Alaska	1991	111,000	6,800	6.13%
Alabama	1990	728,000	14,000	1.92%
	1991	726,000	7,000	0.96%
	1992	730,000	7,000	0.96%
Florida	1988	1,721,000	46,000	2.67%
	1989	1,772,000	36,000	2.03%
	1990	1,862,000	26,000	1.40%
	1991	1,894,000	28,000	1.48%
Michigan	1988	1,583,000	40,000	2.53%
	1989	1,577,000	10,000	0.63%
	1990	1,577,000	5,000	0.32%
Ohio	1991	1,775,000	13,000	0.73%
	1992	1,787,000	5,900	0.33%

Virginia currently has a public secondary school enrollment of approximately 1,056,000 students. Based on sales trends experienced by other states, Virginia could expect to sell about 25,000 contracts in the first year of operation, with continued annual sales of around 10,000 contracts per year. These projections assume a program that would be structured similar to programs in Alabama or Ohio and no change in other factors that might affect sales.

This volume of sales is consistent with the experience with the College Savers Bonds but must be researched further through more traditional market analysis procedures and techniques.

V. Financial Analysis

This section of the report provides some information on the financial conditions that a pre-paid tuition program would face today. A more complete analysis must be conducted to determine the financial feasibility of initiating such a program and an accrual analysis to

determine the pricing policy and rates to be considered.

The recent history of tuition increases indicates an average annual increase of approximately 9 % for the nation and more than 10 % for Virginia. The net investment yield on funds received into a pre-paid tuition program would have to approximate the Virginia rate for the program to be self-sufficient. Otherwise parents would not receive the benefit they expected, a year's worth of tuition payment, or the state might be expected to make up the difference from state or other institutional funds. A brief examination of various investment options may provide some insight into the probability of the feasibility of such a program.

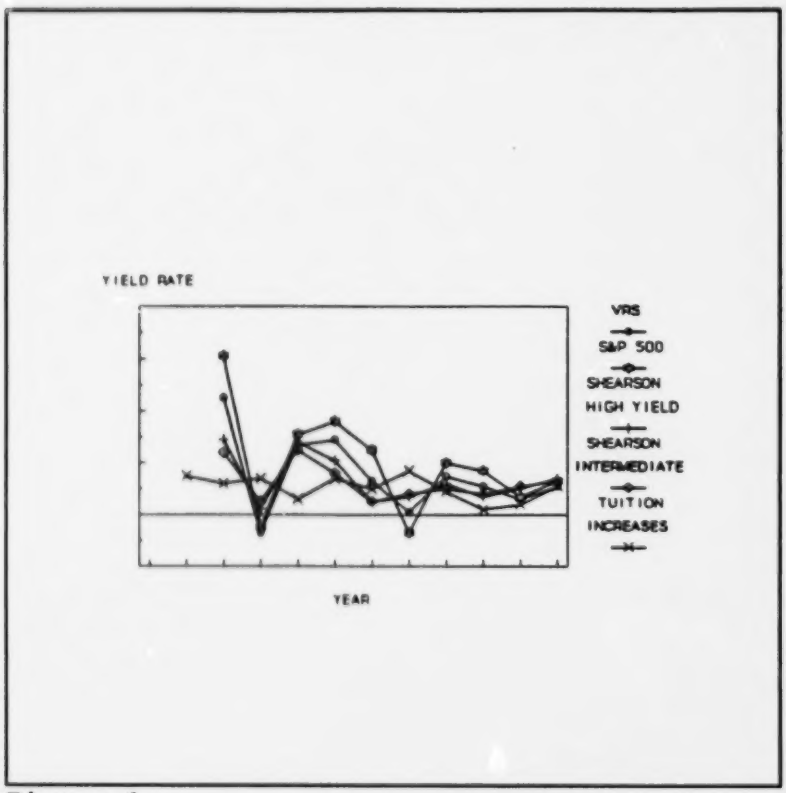

Figure 1

The average yield on the general fund, federal 90-day Treasury Bills, or a composite of 134 money market funds does not approximate the recent history in tuition increases. Figure 1 provides a comparison of actual investment yields and actual tuition increases. The tuition increase from 1981 to 1992 reflects an compounded rate of 10.3 %. The internal rate of return on the general fund was 8.7 %, on 90-day Treasury Bills was 7.4 % , and on the typical money market fund it was 7.3 %. If these were the only investment options available, a pre-paid tuition program would not provide the benefit expected or the state would have to augment the investment yield to provide the tuition payment. A more aggressive investment approach might be needed.

An approximation of the investment yield available from other options might be estimated from the yield of the Virginia Retirement System or commercial equity fund options. Figure 2 provides a summary for the VRS portfolio, the average of the Standard and Poor's 500 corporations and the Shearson-Leaman high yield and intermediate yield funds. All four have provided a yield well in excess of the tuition increases with an internal rate of return for the VRS of 15.32 %, for the S&P 500 of 19.96, of 13.6 % for the high yield fund, and 12.5 % for the intermediate yield program.

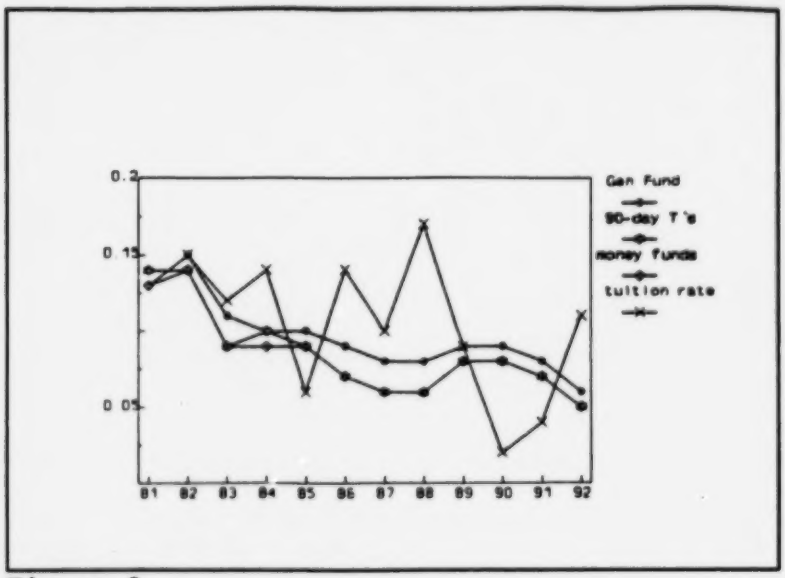

Figure 2

While it appears that a combination of investment approaches and a strong actuarial basis for pricing of a pre-paid tuition program should provide a financially feasible program, it is very dependent upon the assumptions used regarding the tax implications for the parents and the administering organization. Given the current mixed signals, it is not possible to draw any further conclusions at this time.

Other states are going forward with their pre-paid programs and incorporating very conservative assumptions about the tax implications for the parents and investment yields. Most states reprice the contracts each year to reflect the current market conditions and changes in tuition rates. Florida, Alabama, and Ohio appear to have approaches that Virginia should examine closely.

Further analysis of the financial requirements, including estimated operating costs, should be developed by the Treasurer and the Council of Higher Education before any final decision is made on program design or implementation.

V. Observations and Recommendations

Discussions with legislators, students, and parents indicate significant interest in programs that will help students and parents pay for higher education. Helping families plan for and be better prepared for college could yield benefits to the Commonwealth in terms of increased academic preparation of future college students, better awareness of family responsibility and willingness to accept the responsibility, lessened demand for state general fund for student financial aid, and increased retention and graduation rates for both high school and college students.

The Commonwealth needs to address the existing concerns of parents and to provide sufficient incentives for parents to help themselves and their children be prepared for higher education. Because of uncertainty regarding the tax liability of pre-paid tuition programs and the lack of an acceptable market survey to determine the potential short-term and long-term continuing demand for a Virginia Pre-Paid Tuition Program, the Council of Higher Education is not ready to recommend immediate implementation. However, the benefits of reopening the college savers program and possibly initiating a pre-paid tuition program in the future are such that inactivity is not a desirable outcome of this study.

Recommendations

1. **The Commonwealth should expand its information programs targeted at parents of young children and secondary school students to increase their awareness of the costs of higher education and their responsibility for preparing for those costs.**

Parents must be encouraged to start saving as early as possible if college is to remain readily available to Virginia's students. This seems to be an issue of awareness for all socio-economic groups and regions of the state. For some families, it is knowledge of options that should not be foreclosed because of lack of planning. For others, it is reality therapy on the potential that someone else will be responsible for the cost of education of their children. For still others, it is broadening their knowledge of options for resource accumulation and investing.

2. **The Commonwealth's information program should promote federal, state, and private industry programs, since a comprehensive package of options will be needed to meet the diverse needs of Virginia's population.**

There are numerous savings vehicles available in the financial services marketplace for those willing and able to investigate the possibilities and establish a disciplined savings routine. Most families, however, do not because they find personal financial planning difficult to understand, they do not trust many of the product providers, and they do not think about it.

Establishment of a savings program or programs could serve several purposes. The creation of a program would draw attention to the need for savings and prompt a certain number of families to begin saving just because they are advised to by experts and authorities in the field.

Creating a savings vehicle that is easily understood would cause some families to begin a savings program. Finally, the connection to the Commonwealth of Virginia would cause some families to begin saving because they would feel that they could trust such a program.

No single program can meet the needs of all citizens or will be equally attractive to all potential customers. Sharing of resources and expertise through a coordinated marketing program will expand the number of options that can be made available, and the increased competition among the products may improve the quality of products and benefits to the parents and students.

3. **The Commonwealth should examine the feasibility of activating the college savers bonds in 1994.**

The initial issue was very popular, and similar programs in other states appear to be very successful. There are problems with the format used in the initial issue that need to be resolved, but the public demand for such a savings vehicle is sufficient and the educational and fiscal advantages to the Commonwealth justify moving ahead with deliberate speed.

The full cost of the college savers program should be paid out of an administrative fee on the bonds. Alternatively, a direct appropriation to the Treasurer or Council of Higher

Education could be used to fund the administrative and fixed costs of operating the program. Costs that vary by issue should be included into the pricing decision at the time of issue.

Institutional debt and debt of the College Building Authority might be logical vehicles for the savers program. Selection of specific bonds to be designated as College Savers should be vested with the treasurer and the Treasury Board. The General Assembly should establish the policy that such bonds will be made available on a regular basis.

4. **The Treasurer should be asked to investigate the federal and state income tax implications of a pre-paid tuition program and recommend to the Governor and the General Assembly in advance of the 1994 session on the most advantageous structure for the program, the financial feasibility of implementing it in 1994, and the administrative organization needed to operate and market the program.**

The resolution of the Michigan appeal is critical to any decision to proceed and to the financial analysis of any program considered. Changes in the financial market may also influence the financial analysis. Until such time as these concerns are resolved, it would not be wise to move forward with legislation creating an authority to operate such a program or to assign the responsibility to an existing state agency or organization.

5. **The Commonwealth should conduct a preliminary market analysis to determine the extent of interest in both the college savers and pre-paid tuition programs. Responsibility for the market survey should be assigned to the Treasurer and the Council of Higher Education. Research or survey centers within the colleges and universities should be used in the design and conduct of the study. Funds should be appropriated for this purpose in the 1993 session of the General Assembly.**

Although the outcome of the tax liability ruling may make the financial feasibility of actually implementing a pre-paid tuition program unrealistic, it is essential that the Commonwealth have a reasonable estimate of the potential market for such a program. Sufficient volume is needed to justify the large investment to initiate and operate such a program.

6. **Parents and students should assume the majority of risk in any college savers program, not the institutions or the state. Risk should be shared between parents, institutions, and the state, if a pre-paid tuition program is implemented.**

If the yield from investments of the revenues from the sale of pre-paid tuition contracts does not offset increases in tuition, and possibly room and board rates, at the time the student is ready to enroll, there must be a clear understanding of who will be responsible for the difference. Although this is a detail that does not need to be resolved until it is determined that it is feasible to actually implement a pre-paid tuition program, some discussion might be helpful to the understanding of the contemplated program.